

TESTIMONY OF WENDY DOLBER
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SUBCOMMITTEE ON FEDERALISM AND THE CENSUS

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Introduction

Mr. Chairman, Members of the Subcommittee. Good morning. I am Wendy Dolber, Managing Director of Standard & Poor's Ratings Services ("S&P"). I manage the tax-exempt housing group within the Public Finance Department of Corporate and Government Ratings, and we rate debt issued in connection with affordable multifamily and single-family housing.

We work with issuers, such as municipalities, state and local housing finance agencies (HFAs), public housing authorities (PHAs), for-profit and not for profit developers and special purpose entities. Our sector includes a broad range of affordable housing financings. In the multifamily sector, we rate issues backed by affordable multifamily properties, individually or in pools, unenhanced or supported by insurance or loan guarantees, and annually appropriated funds. In the single-family area, we rate pools of loans, which may be insured or guaranteed, or uninsured. In addition to rating bond issues supported by explicit collateral (issue ratings), we also provide issuer credit ratings (ICRs) of the issuers themselves. S&P currently has more than 3,350 outstanding issue ratings, as well as 25 HFA issuer credit ratings. For reasons to be discussed later in this testimony, currently, S&P has only assigned issue ratings to PHA debt.

I am here today to provide testimony regarding S&P's view of PHAs in the competitive marketplace. In order to have the most effective and efficient financing programs, PHAs need to have the flexibility and expertise to choose among an array of financing options. PHAs have historically entered the bond market through the use of pledged collateral often supported by Federal subsidies, and/or insurance and loan guarantees. The passage of the Quality Housing and Work Responsibility Act (QHWRA) in 1998 opened the door to leveraging of HUD funding. While this expanded financing opportunities greatly, for the first time it required market understanding and acceptance of Federal appropriation risk and confidence in PHA performance. While S&P has assigned high investment-grade ratings to these transactions, and market acceptance has been positive, only a small percentage of PHAs have issued bonds to date.

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In considering how PHAs can take full advantage of available financing options,
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there are
several factors that lead toward a successful outcome:

- Predictability, stability and fungibility of income sources.
- Clarity, consistency and dependability regarding the HUD regulatory environment, especially as it relates to the leveraging of Federal funding.
- Clear direction concerning the potential for and impact of sanctions for poor PHA performance.
- Effective and timely communication with the capital markets --upfront and ongoing disclosure is critical to PHAs' ability to attain and maintain credit ratings and achieve a competitive advantage.
- PHAs' continuing development of management practices on a par with the private market, especially in the areas of asset management and financial expertise, with the necessary flexibility to achieve best practices.

My comments will address four broad areas:

1. Overview of Standard & Poor's affordable housing bond ratings
2. PHA issue ratings and the impact of performance and appropriation risk
3. PHA capital fund securitizations: Observations on the process
4. Issuer Credit Ratings: Applicability to the PHA industry

1. Overview of affordable housing bond ratings

S&P's ratings address the question, "What is the likelihood of payment according to the

terms of an obligation?" Our ratings are divided into several categories, ranging from

'AAA', indicating the strongest credit quality, to 'D', reflecting the lowest.

Investment-

grade ratings range from 'BBB-' --indicating adequate protection for bondholders, but

susceptibility to adverse economic conditions -- to 'AAA' --indicating extremely strong

capacity to meet financial commitments. In general, the higher rating the lower the interest rate on the debt instrument.

S&P provides a rating only when there is adequate information available to form a credible opinion, and only after applicable quantitative, qualitative and legal analyses are

performed. In assigning issue ratings in the affordable housing sector, we analyze the

security for the bonds, including mortgage or real estate collateral, investments and

reserves, as well as legal structure, cash flows, bankruptcy issues and applicable management practices. It is beyond the scope of this testimony to go into greater detail

about our rating criteria, but I invite you to visit our free website, www.standardandpoors.com, which provides a full discussion of our ratings methodology, criteria, and our current ratings.

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The issue ratings on affordable housing debt tend to fall into the following broad categories:

- Full credit enhancement at the bond level: Single-or multiple-asset financings with full credit enhancement on the bonds, such as letters of credit, or bond insurance tend to be rated according to the ratings of the credit enhancer. The typical rating is 'AAA'.

- Full credit enhancement at the mortgage level: Single-or multiple-asset financings with credit enhancement on the mortgages such as GNMA, FNMA, and FHLMC guarantees also tend to carry the credit rating of the enhancer.

However, reserves and cash flows must also support the rating level. A typical rating is 'AAA'.

- Partial credit enhancement at the mortgage level: Single-or multiple-asset financings with partial credit enhancements, such as FHA insurance will be rated as high as the credit enhancer if shortfalls and reserves are also covered at the same rating level. The typical rating is 'AAA'.

- Unenhanced (no credit enhancement) mortgages: Single-or multiple-asset financings where the debt is supported only by loan or project revenues, with or without Federal subsidies. For multifamily single-asset transactions, ratings are determined based on a full real estate analysis. Quality and management of real estate, as well as debt service coverage, are key rating factors. The typical ratings are 'A' and 'BBB'.

- Packaging pools of loans with sufficient credit support to withstand Standard & Poor's stress scenarios can achieve higher ratings. Typically, issuers use tranching structures and overcollateralization to meet rating standards. The entire rating scale is represented.

- Debt supported by annually appropriated Federal funds: PHA capital fund securitizations are rated based upon the strength and the track record of Federal funding, debt service coverage and legal provisions that guard against HUD sanctions for poor performance. The typical ratings are 'AA'.

- Military housing privatizations also fall into this category. The rating approach is a combination real estate analysis and analysis of the strength of Department of Defense Basic Allowance for Housing payments. The typical ratings range from 'A' to 'AA'.

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2. PHA issue ratings and the impact of performance and appropriation risk Background

PHAs have been active in the bond market for many years, but only recently in their role

as operators of traditional public housing. Prior to the passage of QHWA, debt issued

by PHAs (including housing and redevelopment authorities) was supported by single, or

in rare cases, multiple, multifamily properties or loans, as well as single-family loans.

These are supported by Section 8 project-based subsidies, FHA insurance, or GNMA, FNMA, FHLMC guarantees. S&P rated and continues to rate many of these issues, in the

low to medium investment-grade levels. These types of financings are relatively straightforward, do not include PHA performance or appropriation risk, and are widely

accepted in the marketplace. A small group of PHAs issued bonds supported by unsubsidized and unenhanced properties. Because of real estate risk, including management capacity of property owners, this type of financing attracted a smaller investor base. S&P rated many of these issues in the 'BBB' and 'A' category.

Generally,

investors have become more skeptical about unenhanced project based financings as many properties have suffered from market downturns and ever-increasing operating expenses. For this and reasons of efficiency, the market is moving more toward pooled

financings of multifamily properties, which can provide insulation from performance risk

by reserving against worst case default scenarios.

Capital Fund Securitizations

QHWA opened the door for PHAs to issue debt backed by capital and operating fund

appropriations. HUD focused its attention first on capital fund securitizations. This marked a substantive change in the way PHAs have to interact with the capital markets. Previous financing structures did not require analysis of PHA funding levels or general performance under traditional public housing programs. S&P identified two key risks that need to be addressed to attain and maintain issue credit ratings:

Appropriation Risk

In capital fund securitizations, the payment of bond debt service is directly related to the sufficiency and timeliness of capital fund appropriations. At the time of the first capital fund securitization in 2001, the industry was able to make a strong case for the history of capital fund appropriations and the steps taken to ensure a high level of predictability about each PHA's allocation. In assigning investment grade ratings, S&P looked for excess coverage of capital funds to bond debt service in order to protect bondholders against reductions. However, during the five years since S&P rated the first PHA issue, reductions in capital fund appropriations have been paring excess coverage. To date, no ratings have been affected, but further cuts could compromise a PHA's ability to pay debt service in the future, which could result in lowered ratings. Should that happen, market confidence could be negatively affected.

While it is clear that the Federal government supports public housing, the funding trend is toward increasing tenant vouchers and decreasing capital and operating funds. The aforementioned excess coverage certainly helps to insulate bondholders against these cuts, but more predictability and stability in the level of annual appropriations could

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□ decrease the need for such high levels of excess coverage and stretch the Federal dollar as a leveraging tool for rated bond finance, as well as other financing options. Alternatively, some type of backstop funding mechanism, not subject to Federal appropriations, could greatly enhance confidence in these types of financings.

Performance Risk

Performance risk as it relates to timely payment of debt service is the second key rating factor in capital fund securitizations. There are three questions that need to be addressed:

1. What is the impact of failure to comply with HUD regulations? Failure to comply with certain HUD regulations can potentially negatively affect funding levels, such as failure to obligate and expend capital funds. Clear regulations and accurate ongoing information are critical to addressing this concern.
2. What is the impact of poor overall performance under HUD's assessment system?

If a PHA is labeled "troubled" or is being taken into receivership, it must be clear what the impact of such actions would be, and whether they would affect a PHA's ability to make debt service payments.

3. Can the PHA demonstrate an acceptable level of administrative practices and track record to carry out its responsibilities under the bond program?

For capital fund securitizations, performance risk was lessened greatly when HUD agreed

to provide written acknowledgement on each transaction that if a PHA were sanctioned for poor performance, the sanction would not reduce the funding level below that needed

to make debt service payments to the extent of the law. In addition, HUD allowed PHA

capital funds to be paid directly to the bond trustee through the Line of Credit Control

System, which effectively insulated bondholders against operating risk. These assurances

allowed high investment grade ratings, as long as S&P could analyze a PHA's general readiness to carry out its obligations under the bond program, especially its ability and

track record in obligating and expending HUD funds. In the limited universe of capital

fund ratings so far, PHAs have demonstrated adequate performance. There have been some instances where poor obligation and expenditure history, failure to complete contracts, high turnover and lack of institutional procedures resulted in low management

scores. In these instances, S&P was not able to assign investment-grade ratings.

3. PHA Capital Fund Securitizations: Observations On The Process

S&P has rated more than \$2 billion in PHA capital fund securitizations for 63 PHAs, and

has provided confidential credit assessments on over 100 transactions. Our observations

on the process of working with PHAs, HUD and the marketplace in developing criteria and providing ratings, are as follows:

- While more and more PHAs are testing the waters, PHAs as a group seem very reluctant to move forward with bond financing or other financing options. It is our opinion that lack of familiarity with the marketplace and its players, concern

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□ about possible negative impact on HUD funding, and potential liability to the PHA are the main reasons the majority of PHAs have not participated more fully.

- Pooled financings can increase financing efficiency and could be very beneficial for smaller PHAs that are unlikely to enter the capital markets on their own. However, the benefit of pooled financings is limited because PHA's funding cannot be cross-collateralized.

- It would be beneficial to the PHA's, and to the marketplace in general, if clear regulations regarding leveraging HUD funds were issued. This would increase transparency and greatly enhance the recognition of the financing options available for both the issuer and the market.

- In addition, there is a need for greater understanding between the PHA's as to the

best way to approach the marketplace and to keeping it informed. As with any new skill, a training program might prove useful to acquaint PHA management with best practices used in accessing the bond markets and maintaining regular communications with it.

4. Issuer Credit Ratings: Applicability To The PHA industry

Affordable housing providers in the United States and social housing providers in

the United Kingdom have taken advantage of ICRs as part of their financing strategies. ICRs, which indicate S&P's opinion of the creditworthiness of an issuer's general obligation to meet its financial commitments, offer a high level of flexibility to an issuer, and are one way of identifying performance strengths and weaknesses.

The key components of an ICR will vary according to the unique characteristics of the entity being rated. For example, HFAs, as real estate lenders, are assessed according to general management processes, single-family and multifamily underwriting standards and asset management; financial strength, including profitability, asset quality, leverage, liquidity and capital adequacy; quality of mortgage loan collateral; state economy and the relationship with state government.

Over the years, market participants, such as HUD, insurers and swap providers, have looked to HFA ICRs to evaluate financial strength, management and asset quality. For

example, under the HUD HFA risk-sharing program, HFAs with 'A' rated ICRs were afforded streamlined processing and lower reserve levels. Bond insurers and other credit enhancers routinely look to HFA ICRs in their underwriting. Because of their strong financial track record and excellent management processes, HFAs have achieved ICRs ranging from 'BBB' to 'AAA'. More HFAs are issuing bonds rated based on their ICR, which allows them to benefit from the financial flexibility of backing debt with their general credit rather than the restricted revenues from specific pledged assets.

Since 1997, S&P has issued five ICRs for UK housing associations, all in the medium investment-grade range. (In addition, UK housing associations have issued bonds

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□ collectively using special purpose entities. The bonds have achieved high investment grade ratings based on the credit strength of pools of properties overcollateralized to S&P's rating levels.) S&P's ratings on UK housing associations indicate strong government support, an established regulatory framework and robust financials. While there are distinct differences between U.S. PHAs and U.K. housing associations, there are many similarities that lend themselves to a similar rating approach.

In contemplating ICRs for PHAs, S&P's analysis of appropriation risk will need to be expanded to include operating fund, as well as capital fund appropriations. General management, as well as property and asset management practices will need to be fully understood and evaluated. The current movement to project based asset management will be critical to S&P's ability to assess the financial health of individual PHA assets, as well as PHA performance in managing its portfolio. Because of ongoing regulatory changes in the industry, funding variations and new PHAs financing programs, the flow of clear,

accurate and timely information will be critical to maintaining ratings and investor confidence.

In closing, I would like to take the opportunity to thank the Chairman and the Subcommittee for inviting Standard & Poor's to participate in this hearing. I would be happy to answer any questions.

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